



Federal Excise Tax Evasion Has Driven Explosive Growth of Mislabeled “Pipe Tobacco”

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\$4.1 Billion in FET Lost Since April 2009

\$784 Million in FET Losses Estimated for 2015

State MSA and Escrow Payments Greatly Reduced

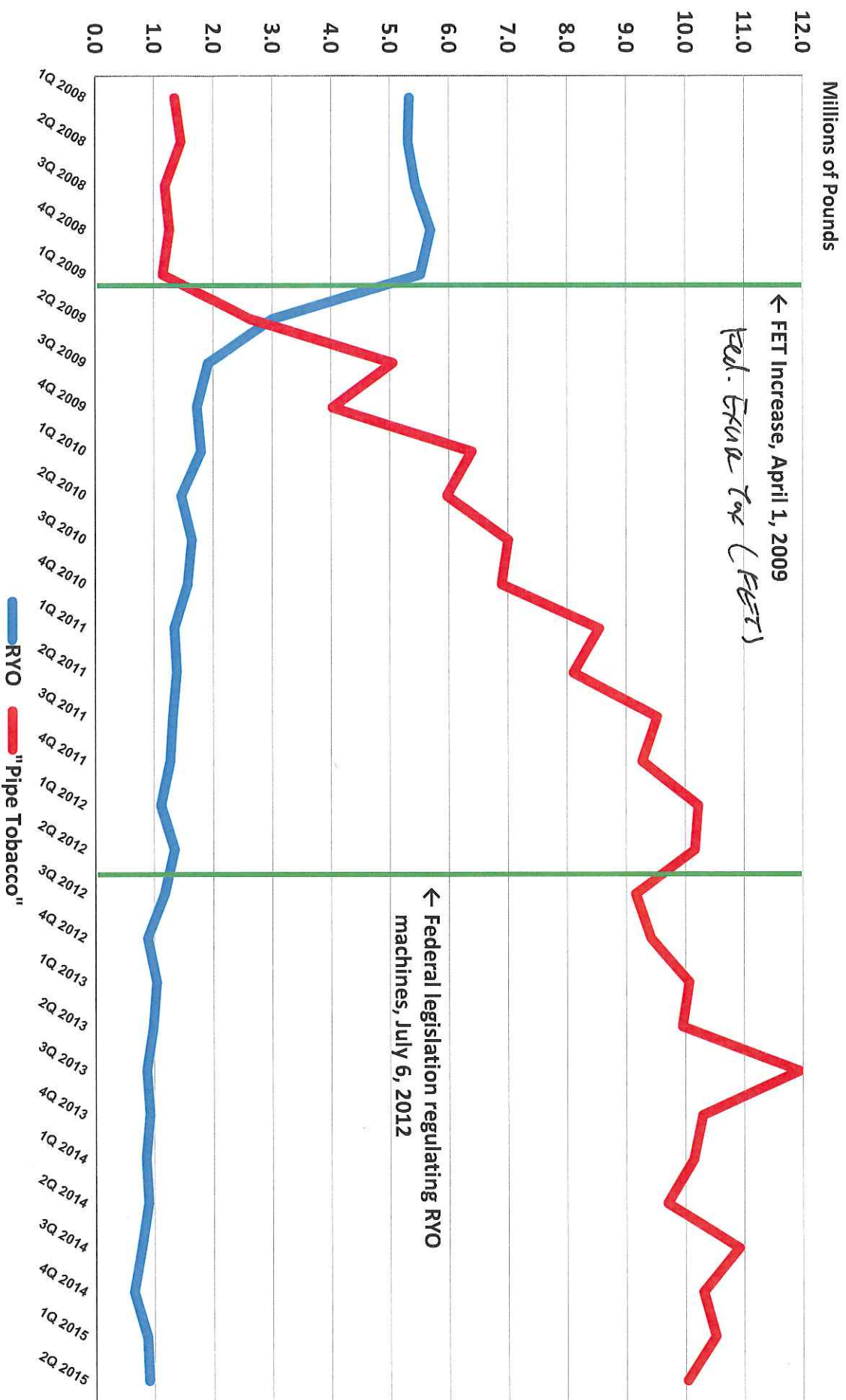
Overview

- Explosion of sales of RYO falsely labeled as “pipe tobacco” and taxed at a fraction of legitimate RYO. *Roll your own tobacco to evade 2008 excise tax*
- Mislabeled “pipe tobacco” accounted for an estimated 6.3% of total cigarette volume in 2014.
- Mislabeled “pipe tobacco” responsible for loss of \$4.1 billion in FET since April 2009 and an estimated \$784 million in 2015.
- CDC data show incidence of genuine pipe tobacco smoking is low and declining.
- *2009-2012 (NTHS)* Sales of leading genuine pipe tobacco brands have been flat to down since 2009.
- Mislabeled “pipe tobacco” meets definition of RYO under 26 USC § 5702(o) and should be taxed as such.
- Failure to enforce proper FET rate results in a huge back-door subsidy to self-selected tobacco manufacturers who are violating the law.

Overview

- Manufacturers of mislabeled “pipe tobacco” have been brazen in making clear to consumers the true intended use of their product through such tactics as:
 - Marketing the product with comparisons to cigarettes, including as substitutes for specific brands.
 - Including cigarette warning labels on their product.
 - Flavoring their tobacco with menthol — which is only used in cigarettes, not in genuine pipe tobacco.
 - Using traditional cigarette descriptors such as “light” and packaging in 16 oz. bags.
 - Marketing their products at trade shows and other venues as tobacco for making cigarettes.
 - Marketing mislabeled “pipe tobacco” with cigarette papers, cigarette tubes, and cigarette rolling machines.

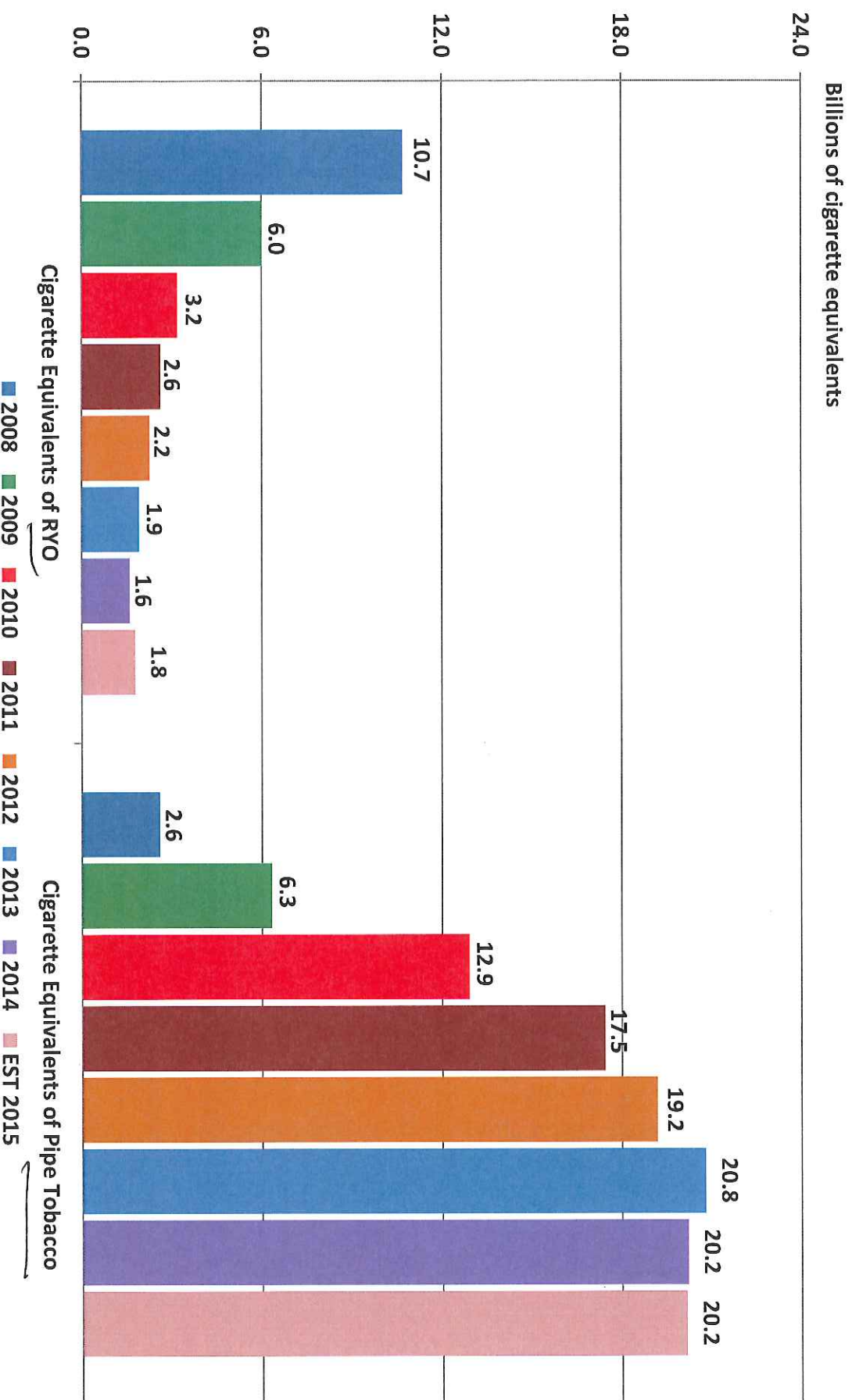
Volume of RYO vs. "Pipe Tobacco" by Quarter 2008-2015



Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau.

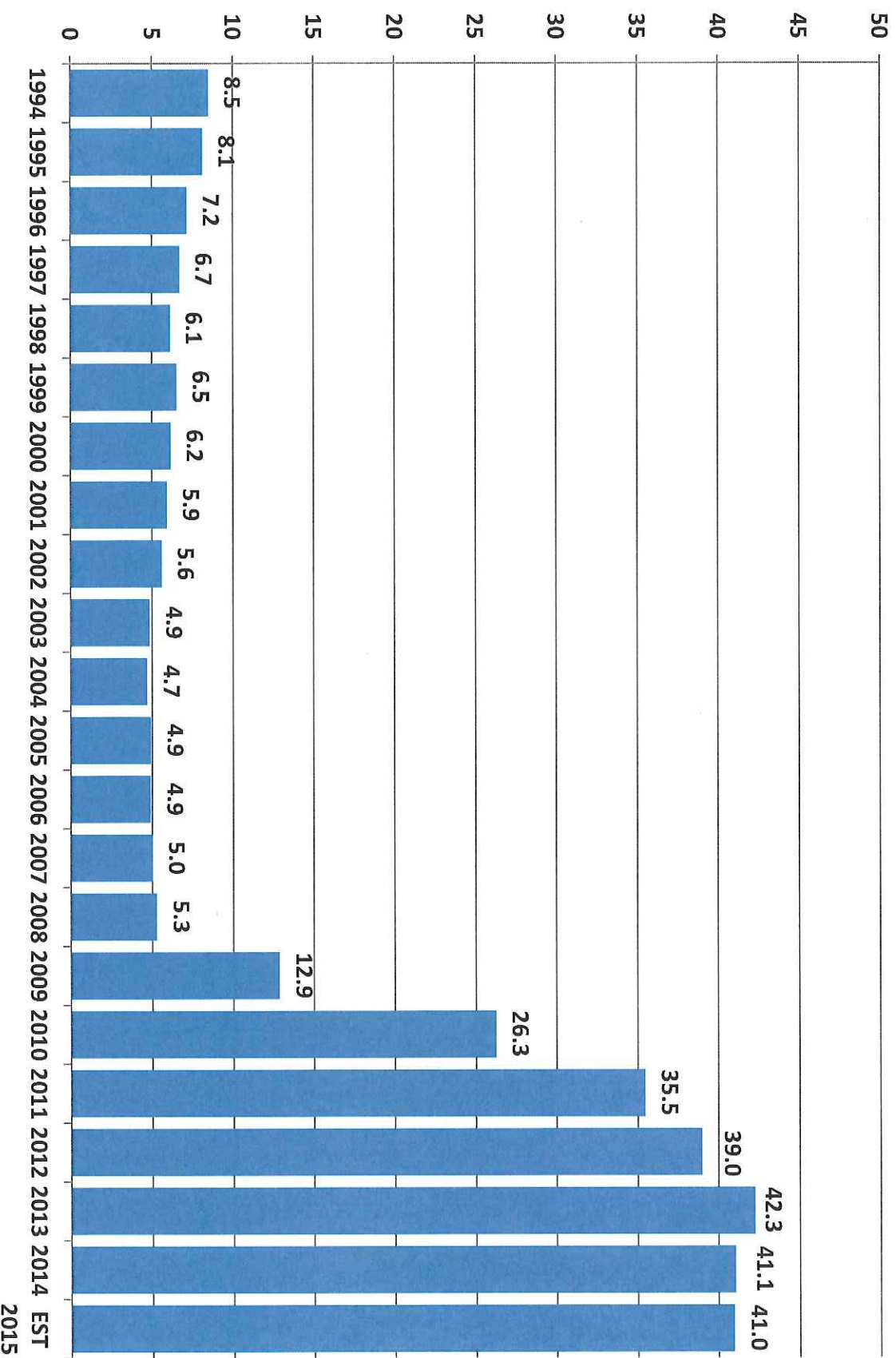
RYO and Pipe Tobacco Volume Changes 2008-2015

Expressed in Cigarette Equivalents



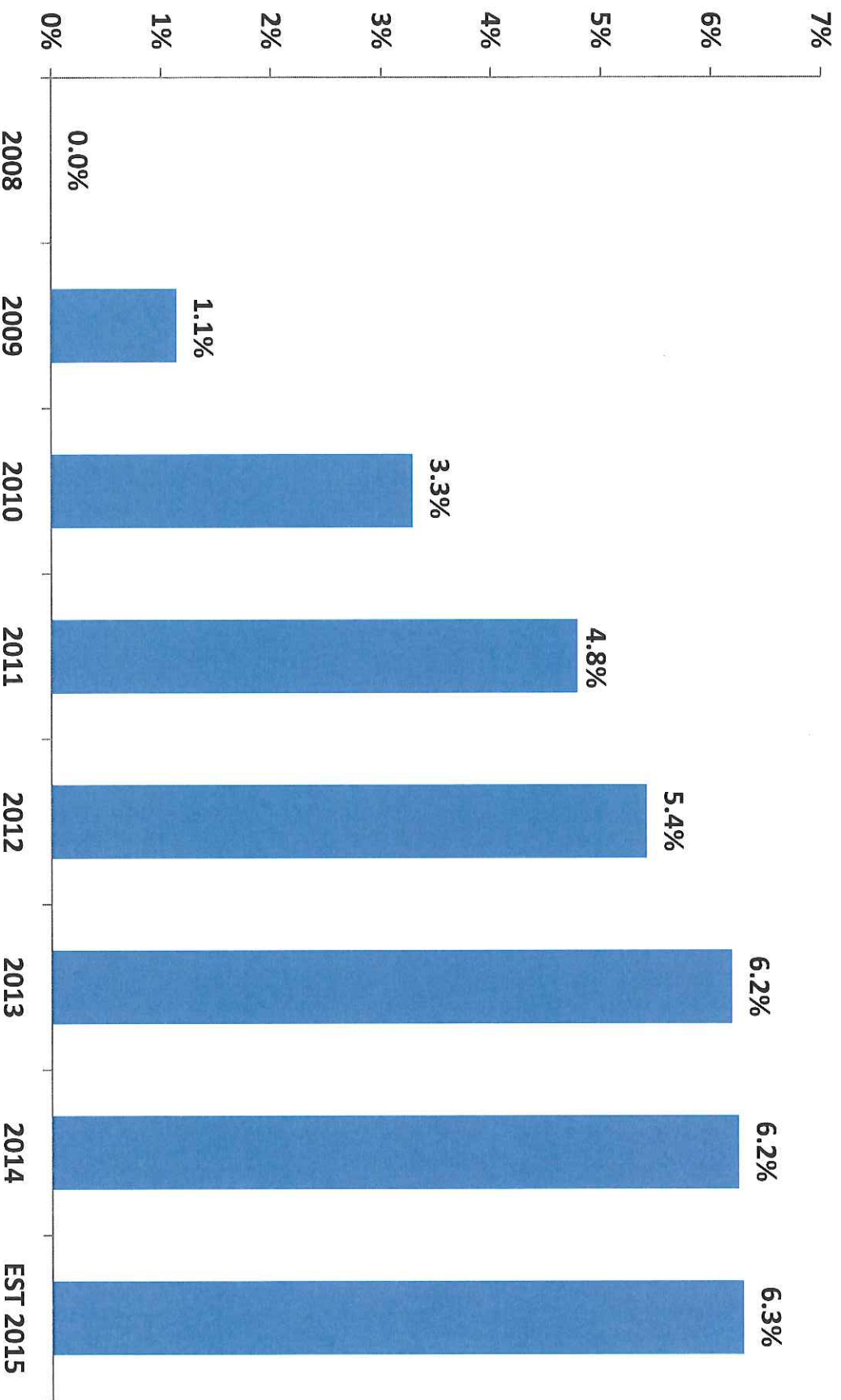
Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau.

Pipe Tobacco Volume 1994-2015 in Millions of Pounds



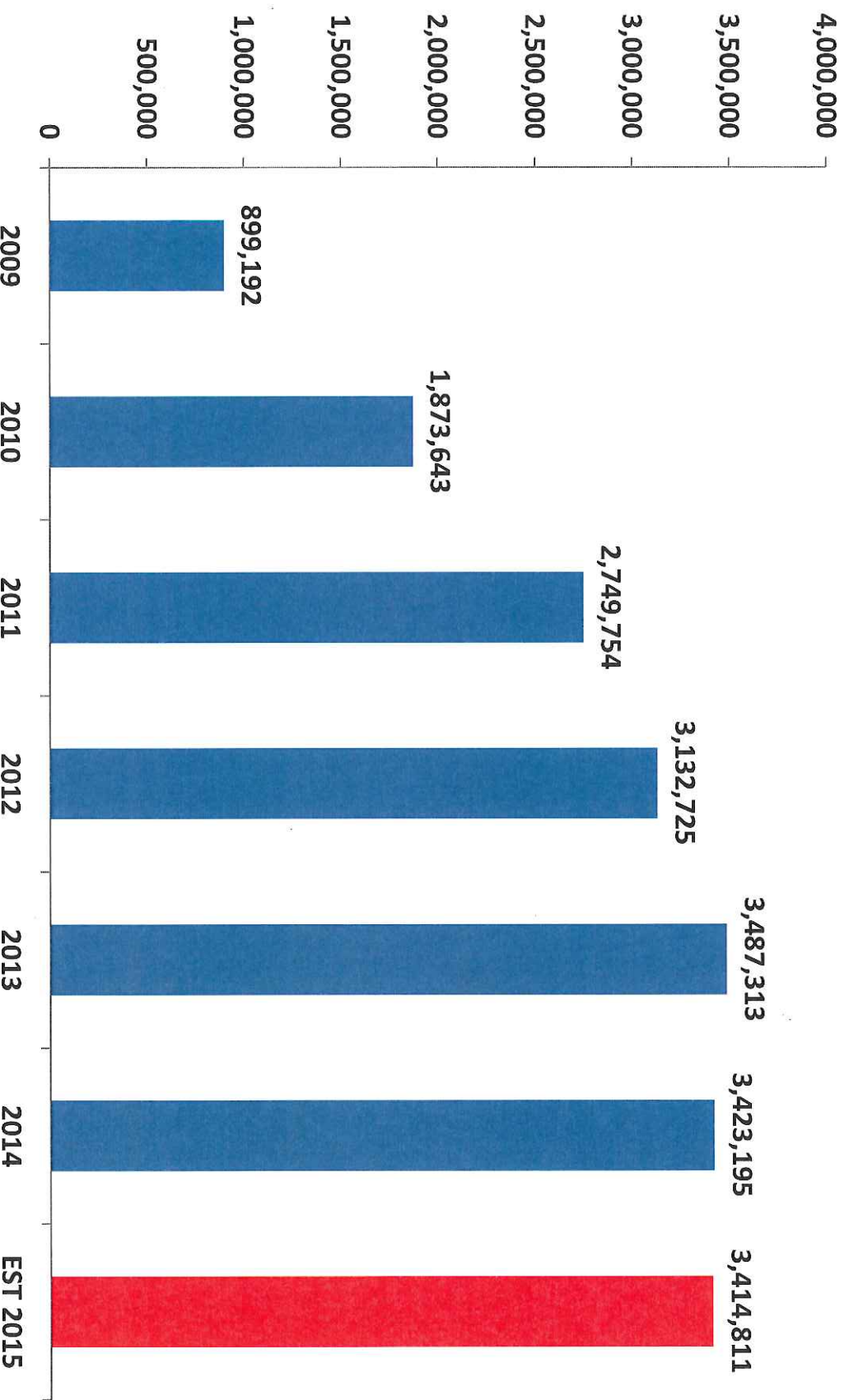
Source: Statistical Reports, U.S. Treasury Department, Alcohol and Tobacco Tax and Trade Bureau

Mislabeled "Pipe Tobacco" Share of Total U.S. Cigarette Market



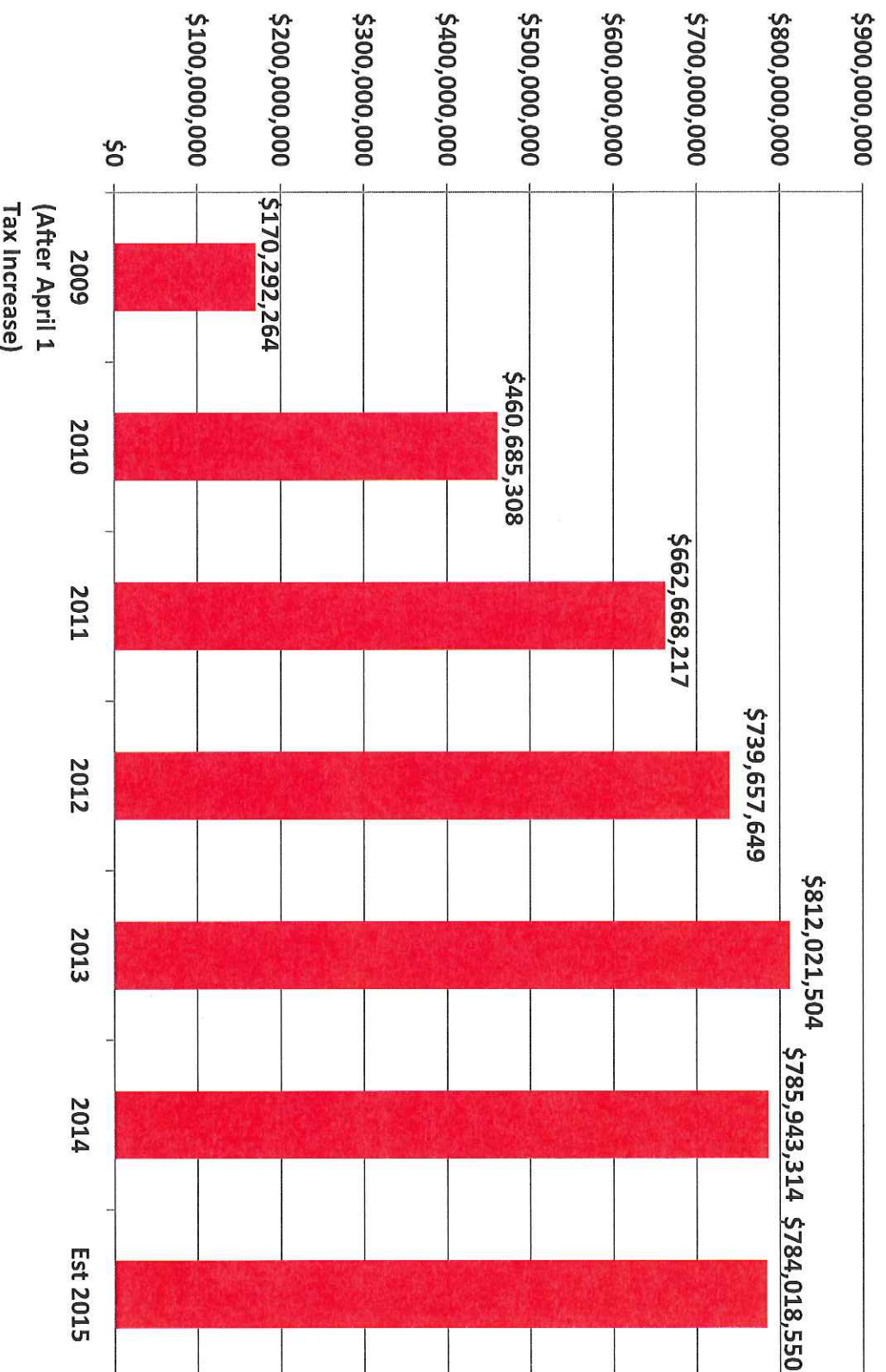
Source: Statistical Reports, U.S. Treasury, Alcohol and Tobacco Tax and Trade Bureau.

Estimated Number of Smokers Using Cigarettes Made with Mislabeled "Pipe Tobacco"



Based on straight-line extrapolation from national mean of 16.7 cigarettes per day (CPD) in 2005 to an estimated 14.2CPD in 2013. See Centers for Disease Control and Prevention, *Morbidity and Mortality Weekly Report*, Sept. 9, 2011, www.cdc.gov/mmwr (Jan. 9, 2012).

Tax-Evasion FET Revenue Losses From Mislabelled "Pipe Tobacco" Not Paying RYO Tax Rate



Approximate 2015 Costs, Including Taxes and Fees, in One Carton of Cigarettes and Cigarette Equivalents

	<u>Cigarettes</u>	<u>Little Cigars</u>	<u>RYO</u>	<u>"Pipe Tobacco" Cigarettes</u>
COG	\$3.00	\$3.00	\$1.00	\$1.00
<u>FET</u>	\$10.07	\$10.07	\$10.07	\$1.15
FDA	\$0.45	0	\$0.45	0
MSA	\$6.48	0	\$2.35	0
SET <i>(state)</i>	\$16.00	\$6.83	\$7.28	\$1.15
Total	\$36.00	\$19.90	\$21.15	\$3.30

NOTES

One carton contains 200 cigarettes. One pound of RYO or mislabeled "pipe tobacco" equates to 492 cigarettes (2½ cartons).

COG: Approximate cost to manufacture and distribute one carton or carton equivalent.

FET: 2009 SCHIP legislation equalized FET on cigarettes, little cigars, and RYO.

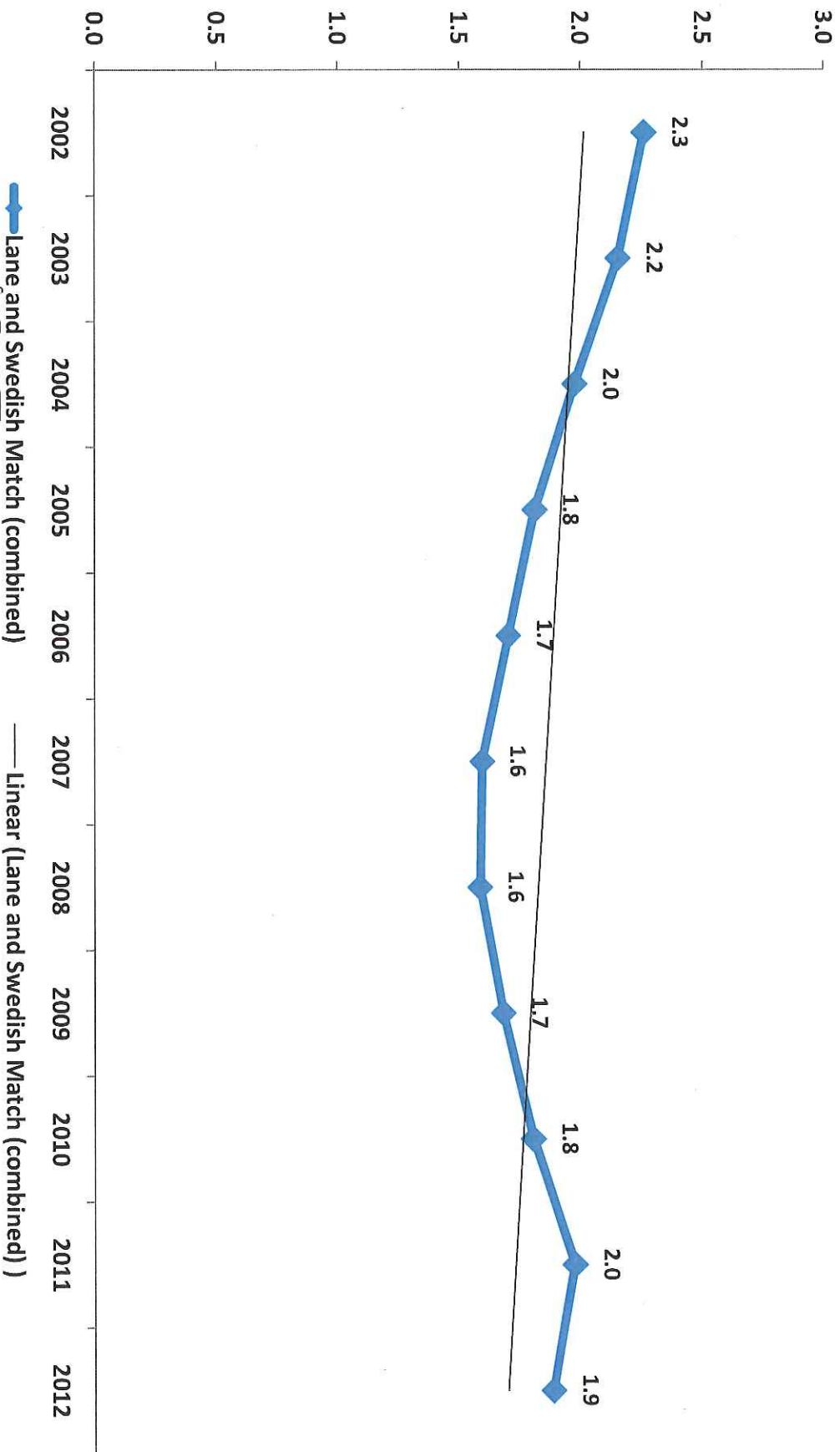
FDA: User fees paid to FDA pursuant to Tobacco Control Act. Based on FET paid. FDA fees do not yet apply to little cigars or "pipe tobacco."

MSA: Master Settlement Agreement payments or related state escrow deposits. MSA and escrow payment apply only to cigarettes and RYO.

SET: National average state excise tax on cigarettes is \$16 per carton (www.tobaccofreekids.org/research/factsheets) (9-28-15). Most states tax other tobacco products (OTP) as a percent of the manufacturer price to wholesale. State OTP taxes vary, but average is approximately 35%. This chart assumes national average OTP tax rate of 35% after a 50% markup by manufacturer.

Two Largest Genuine Pipe Tobacco Manufacturers Have Flat to Declining Volumes

Millions of Pounds



Source: EuroMonitor International 2002-2011. Data for 2012 estimated from EuroMonitor/MSA Data.



Deeming Regulation Should Keep Pipe Tobacco Subject to 2007 Predicate Date Required by Tobacco Control Act

- Under Tobacco Control Act, cigarettes and smokeless tobacco may stay on market only if they demonstrate “substantial equivalence” to a “predicate” product on market as of February 15, 2007.
- Proposed deeming regulation correctly applies this rule to other tobacco products being brought under FDA jurisdiction.
- Final deeming regulation should not change this rule — all tobacco products should be similarly treated, including pipe tobacco.
- Pipe tobacco and other tobacco products should not be exempted from 2007 predicate date requirement to show substantial equivalence.
- FDA has correctly indicated that it lacks the authority to change this statutory requirement by regulation.



Deeming Regulation Should Keep Pipe Tobacco Subject to 2007 Predicate Date Required by Tobacco Control Act

- All tobacco products brought under FDA jurisdiction by deeming regulation should be treated same as tobacco products already under FDA jurisdiction.
- All pipe tobacco — genuine or mislabeled — should be required to demonstrate substantial equivalence to a 2007 predicate product, just as cigarettes and smokeless tobacco are required to do.
- Genuine pipe tobacco brands have been on market for decades with little change.
- Therefore, virtually all genuine pipe tobacco brands will have a 2007 predicate they can use to demonstrate substantial equivalence.
- Mislabeled “pipe tobacco” brands did not exist in 2007 — they only came into existence when RYO was relabeled as “pipe tobacco” to evade 2009 FET increase.
- If they can show substantial equivalence to a 2007 predicate pipe tobacco product, then they may stay on the market — if not, they should come off the market, the same as any other tobacco product.



Manufacturers Violate TTB Policy

TTB has received many questions about how to differentiate between pipe tobacco and roll-your-own tobacco for purposes of the Federal excise tax and related provisions . . .

We are currently evaluating methods to differentiate between the two products and foresee providing specific guidance in this regard in the near future . . .

In the meantime, the packaging and labeling of the products in question will have particular significance. For example, **TTB will consider the extent to which the packaging and labeling for a pipe tobacco product clearly presents the product to the consumer as such and not as roll-your-own tobacco, or whether there are representations or implications on the package or in other materials which tend to contradict the stated tax declaration.**

Source: www.ttb.gov/tobacco/pipe-tobacco.shtml

Federal Tax Code Definitions of Tobacco Products

- “Cigarette” means—
 - (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco, and
 - (2) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in paragraph (1).
- The term “pipe tobacco” means any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco to be smoked in a pipe.
- The term “roll-your-own tobacco” means any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes.

Source: Internal Revenue Code, 26 U.S.C. § 5702(a), (n), (o).

Federal Tobacco Product Definitions — Tobacco Control Act (FDA)

(3) CIGARETTE.—The term ‘cigarette’—

(A) means a product that—

(i) is a tobacco product; and

(ii) meets the definition of the term ‘cigarette’ in section 3(1) of the Federal Cigarette Labeling and Advertising Act; and

(B) includes tobacco, in any form, that is functional in the product, which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette or as roll-your-own tobacco.

(4) CIGARETTE TOBACCO.—The term ‘cigarette tobacco’ means any product that consists of loose tobacco that is intended for use by consumers in a cigarette. Unless otherwise stated, the requirements applicable to cigarettes under this chapter shall also apply to cigarette tobacco.

Source: Subsections 900 (3) and (4) of Federal Food, Drug, and Cosmetic Act, 21 U.S.C. § 387(3) and (4), as amended by the Family Smoking Prevention and Tobacco Control Act

GAO Report Confirms Mislabeling of “Pipe Tobacco”

Representatives of industry and nongovernmental organizations provided examples of current pipe tobacco brands that had been roll-your-own brands prior to CHIPRA, with minimal differences in the packaging and the appearance of the tobacco itself. We also found examples of Internet retailers signaling to customers in their marketing that pipe tobacco was suitable for smoking in roll-your-own cigarettes. One manufacturer of pipe tobacco had designed its label with three-letter markings, to indicate to customers the product's similarity to brand-name cigarettes. For example, the marking MRD indicated Marlboro Red and CML indicated Camel Light.

We approached 15 pipe tobacco manufacturers to ask about their companies' actions in response to the CHIPRA tax changes. Each of the three tobacco manufacturers that agreed to speak with us explained that their companies switched from selling higher-taxed roll-your-own tobacco to lower-taxed pipe tobacco in order to stay competitive. One company changed the cut of its roll-your-own tobacco and labeled it as pipe tobacco, although a company representative acknowledged that there was no real difference between its pipe-cut tobacco and its roll-your-own tobacco. A representative from another company that switched from selling roll-your-own tobacco to selling pipe tobacco stated that she was not aware of any difference in the two products other than the federal excise tax rate.

Large Disparities in Rates for Smoking Products Trigger Significant Market Shifts to Avoid Higher Taxes, United States Government Accountability Office, Report to Congressional Committees, April 2012, GAO-12-475, page 17. See video included in GAO report at: http://www.gao.gov/multimedia/video#video_id=589493

"Pipe Tobacco" Cigarettes Are Unregulated and Unaccountable

- Falsely marketed as safer — "organic" "additive-free" "chemical-free" "all-natural"
- No health warnings
- No fire standard compliant (FSC) cigarette paper
- No ban on characterizing flavors
- No ban on "light," "mild" or similar descriptors
- No product or manufacturing facility registration filed with FDA
- No product ingredients filed with FDA
- No substantial equivalence reports filed with FDA
- No pre-market clearance of new products by FDA
- No MSA or state escrow payments or advertising and marketing restrictions

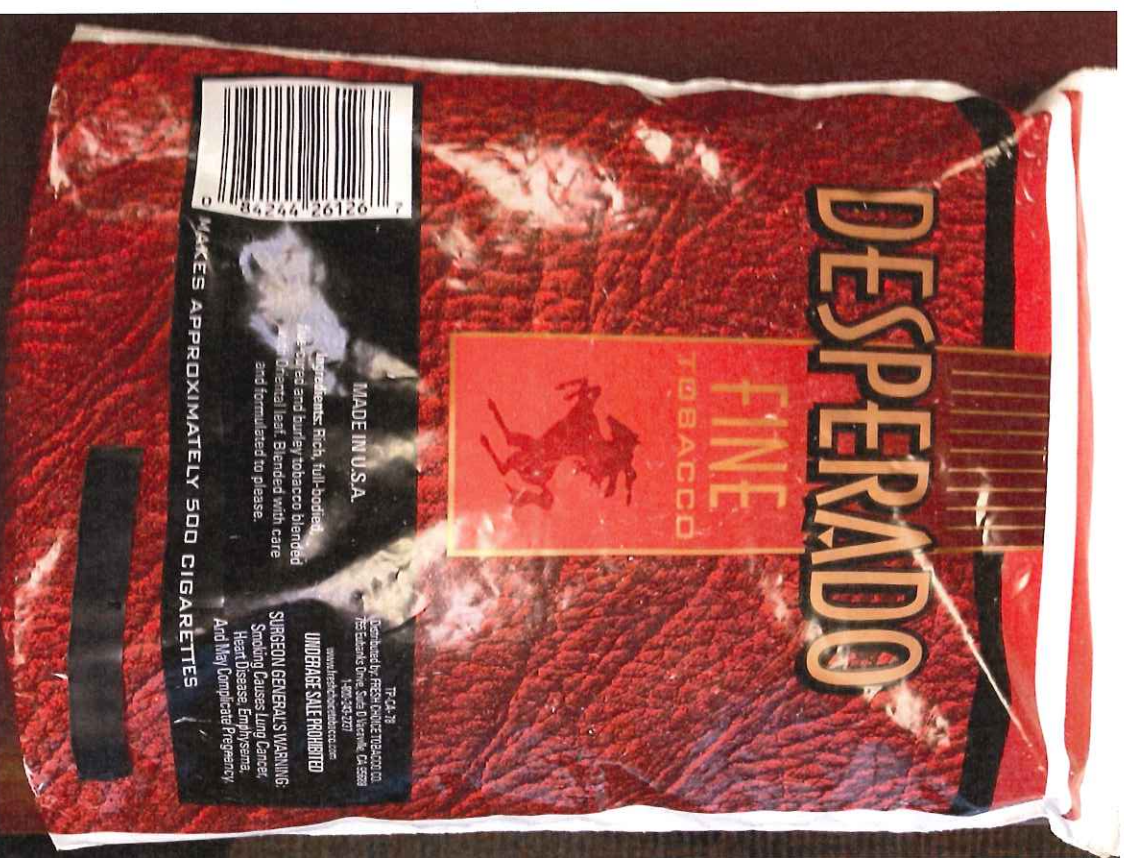
THAT'S
Pipe Tobacco
— very consistent
— no flavors
product

Appearance, Type, Packaging and Labeling — Stickers Used to Relabel RYO as “Pipe Tobacco”



Note: “All Natural Pipe Tobacco” sticker has been applied to front of pre-existing package. Tape on back of package covers up the following words, which can still be read through the sticker: “MAKES APPROXIMATELY 500 CIGARETTES.”

Appearance, Type, Packaging and Labeling —
Tape Used to Cover Statement “Makes Approximately 500 Cigarettes”



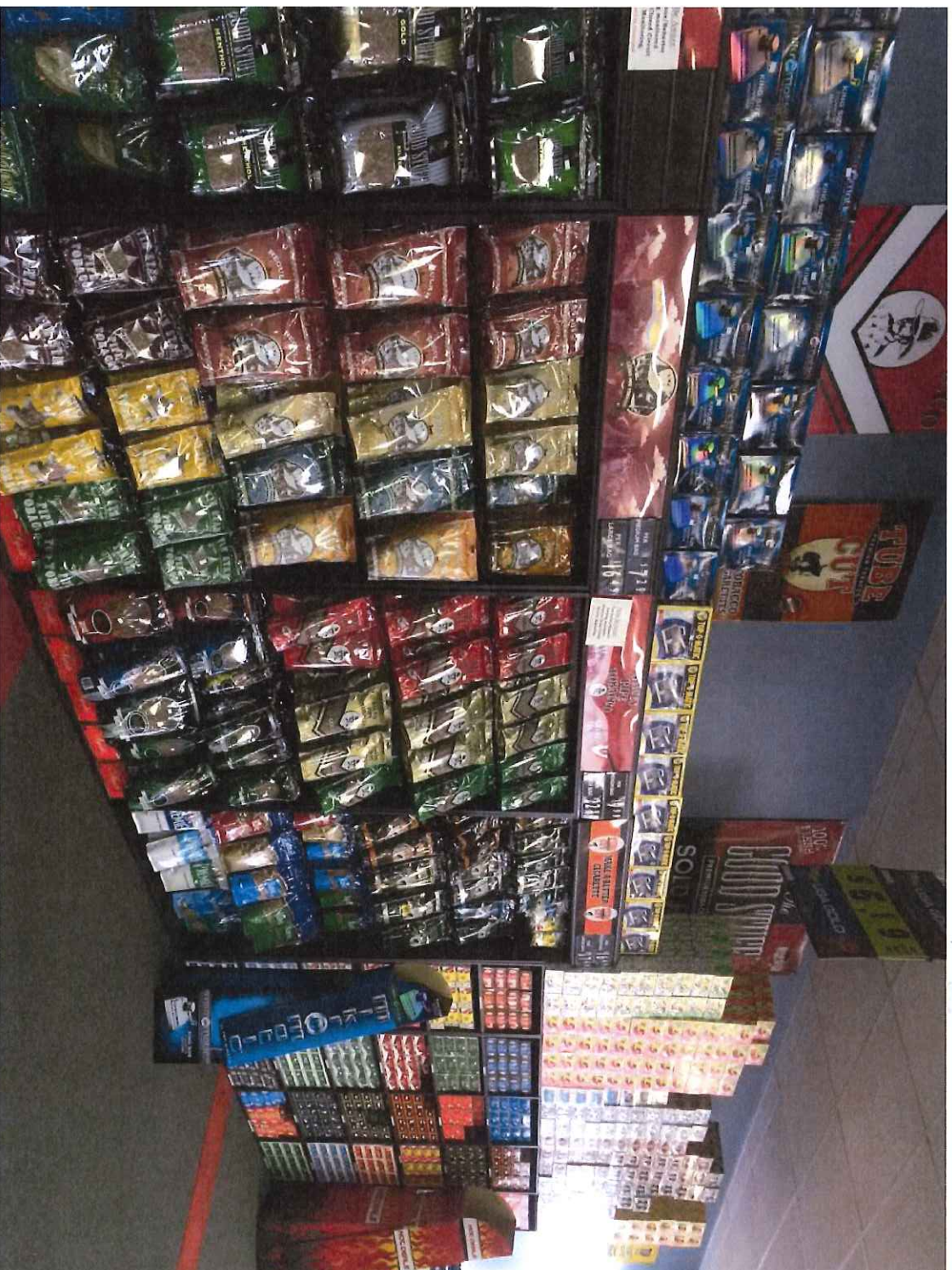
Appearance, Type, Packaging and Labeling —
RYO and “Pipe Tobacco”



Appearance, Type, Packaging and Labeling —
RYO and “Pipe Tobacco”



“Pipe Tobacco,” Cigarette Tubes, and Cigarette Rolling Machines Marketed Together



Janesville, Wisconsin, July 2014